

STATE OF DELAWARE
OFFICE OF
AUDITOR OF ACCOUNTS

CITY OF HARRINGTON

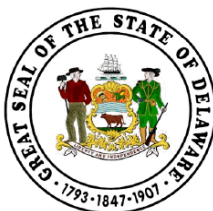
THEFT OF CITY FUNDS

SPECIAL INVESTIGATION

FIELDWORK END DATE: AUGUST 3, 2007

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State of Delaware
Office of Auditor of Accounts
R. Thomas Wagner, Jr. - CFE, CGFM, CICA
At a Glance

Case ID - 2007-027

September 10, 2007

Working Hard to Protect YOUR Tax Dollars

Why We Did This Review

The City of Harrington (City) requested the assistance of the Office of Auditor of Accounts (AOA) to aide them in determining the amount of funds embezzled by the former City Finance Director, and to review the City's internal controls and provide recommendations for strengthening controls within the City.

Concurrently, the State of Delaware Attorney General's Office requested that AOA review the former Finance Director's pension account for propriety of activity. Our review revealed no misappropriations of pension related funds.

Background

The City's former Finance Director was employed from January 6, 2003 through April 20, 2007. Her job duties provided her access to all bank accounts, check stock, and a Lowe's credit card. Upon her resignation, the City discovered several bank overdraft notices. The City performed an internal investigation, which resulted in the arrest of the former Finance Director as well as her daughter and son-in-law for embezzlement of more than \$547,500. Charges include 154 counts of second-degree forgery, 77 counts of theft by false pretense, and one count of conspiracy.

Prior to contacting AOA, the City identified 216 checks totaling \$546,387.04 as forgeries. Investigators from the AOA identified an additional 167 checks totaling \$253,647.51, \$908.02 in Lowe's Credit Card fraud, and \$652.91 in benefits that were under-deducted for a total of \$255,208.44 of additional fraud. The total amount stolen was **\$801,595.48**.

For further information on this release, please contact:
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City of Harrington Theft of City Funds - Special Investigation

What We Found

A weak control environment consisting of a lack of segregation of duties, management review, and reconciliations facilitated the resulting forgeries and fraud. The former Finance Director wrote fraudulent checks forging the signatures of the authorized signers and manipulated the accounting data in the general ledger accounting system. The former Finance Director intercepted the bank statements in order to remove the fraudulent checks; the employee responsible for reviewing the bank statement did not question the missing checks. Bank reconciliations were not prepared or reviewed by management. City Council did not receive monthly reports as required by City Charter 17.3 which states, "The Finance Director shall, at one monthly meeting of Council, present a report showing in detail all bills and other claims for which warrants or checks were drawn the preceding month, with exception of payroll and payroll-related expenses." Numerous transfers were made from other City accounts to compensate for the dwindling bank balances, none of which were authorized or reviewed by management.

The controls within the City are inadequate. The City does not have written policies and procedures. Management is responsible for establishing internal controls through written policies and procedures. The lack of (a) knowledge of internal control and (b) policies and procedures contributed to an environment conducive to fraud.

The previous City Finance Director maintained the accounting records, prepared checks, and prepared bank reconciliations. She was also responsible for receiving and opening Bank statements. This results in a lack of segregation of duties. The lack of segregation of duties and management review provided the City Finance Director an opportunity to (a) alter accounting records, (b) modify checks after authorized signatures were obtained, (c) prepare fraudulent checks, and (d) forge signatures.

The City is currently not performing monthly bank reconciliations. Reconciliations are an essential control to ensure all transactions have been recorded and to identify potential improprieties. The lack of bank reconciliations, management review, and monitoring contributed to a weak control environment and the ability of the City Finance Director to embezzle funds.

What We Recommend

The Office of the Auditor of Accounts (AOA) recommends the City of Harrington do the following:

- Review COSO and gain an understanding of internal control. This includes the five components of internal control: the control environment, risk assessment, control activities, information and communication, and monitoring.
- Develop written policies and procedures to ensure standardization in processing procedures and clarification of job duties. These policies and procedures should incorporate key controls such as segregation of duties, management review, reconciliation, etc. The City should consider hiring a consultant proficient in developing policies and procedures to assist with this process.
- Provide effective oversight and monitor activities to ensure compliance with established policies and practices.
- Segregate duties as much as possible with the limited staff. A management review process should be incorporated. For example, if the City Finance Director is tasked with preparing and mailing checks, then another individual should receive the unopened bank statement, and prepare the bank reconciliation. The reconciliation should be reviewed and approved by a management level position (e.g. City Manager or Mayor).

Please read the complete report for a full list of findings/ recommendations and to review the City's response to our findings.

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Audit Authority

Title 29, Del. C. c. 29 authorizes the Auditor of Accounts to file written reports containing:

1. Whether all expenditures have been for the purpose authorized in the appropriations;
2. Whether all receipts have been accounted for and paid into the State Treasury as required by law;
3. All illegal and unbusinesslike practices;
4. Recommendations for greater simplicity, accuracy, efficiency, and economy; and
5. Such data, information, and recommendations as the Auditor of Accounts may deem advisable and necessary.

ALLEGATION AND BACKGROUND

ALLEGATION

The City of Harrington (City) requested the assistance of the Office of Auditor of Accounts (AOA) as follows:

- Determine the amount of funds embezzled by the former City Finance Director, and
- Review the City's internal controls and provide recommendations for strengthening controls within the City.

The State of Delaware Attorney General's Office requested that AOA review the former Finance Director's pension account for propriety of activity.

BACKGROUND

The City is located in Kent County, Delaware. As of the 2000 census, the City's population was 3,174. The City hosts the Delaware State Fair each July.

The City's former Finance Director was employed from January 6, 2003 through April 20, 2007. Upon her resignation, the City discovered several bank overdraft notices. The City performed an internal investigation, which resulted in the arrest of the former Finance Director as well as her daughter and son-in-law for embezzlement of more than \$547,500. Charges include 154 counts of second-degree forgery, 77 counts of theft by false pretense, and one count of conspiracy.

The former Finance Director's job duties provided her access to all bank accounts, check stock, and a Lowes credit card.

OBJECTIVES, SCOPE, & METHODOLOGY

OBJECTIVES

The objectives of the investigation were:

1. Determine the amount of funds embezzled from the City; and
2. Determine the adequacy of controls within the City and provide recommendations for strengthening controls.

SCOPE

The scope of the investigation was as follows:

- 100% review of non-payroll expenditure activity from November 1, 2004 through May 11, 2007; 100% review of the former Finance Director's pay from July 1, 2005 through April 20, 2007 (last day of employment), and a reasonableness test of remaining payroll from July 1, 2005 through May 11, 2007;
- 100% review of the former Finance Director's pension activity for the duration of her employment with the City (January 6, 2003 through April 20, 2007);
- 100% review of transfers among bank accounts from July 1, 2005 through May 11, 2007;
- 100% review of the former Finance Director's Lowes account activity;
- Sample testing of remaining Lowes account activity; and
- Review of controls from July 1, 2005 through May 11, 2007.

The investigation was performed in accordance with the President's Council on Integrity and Efficiency, *Quality Standards for Investigations*.

METHODOLOGY

The techniques used in this investigation included inquiry and inspection of documentation.

CONCLUSIONS

Objective 1: Determine the amount of funds embezzled from the City.

In order to determine the amount of funds embezzled from the City, AOA examined all non-payroll disbursements originating from the Accounts Payable checking account from November 1, 2004 through May 11, 2007. A total of 4,057 checks were reviewed, of which, 383 were determined to be forgeries. Fraudulent checks made payable to the Finance Director, her husband, her daughter, her son-in-law, Lowe's, and home and auto finance companies totaling \$800,034.55 were processed.

<i>Payee</i>	<i>Number of fraudulent checks written</i>	<i>Amount</i>
Christine Truitt	124	\$ 250,062.20
William Truitt	2	900.00
Nina LeGates Grimes	103	216,527.81
Shaun Grimes	142	296,325.55
Lowe's	5	9,394.19
AMC, Inc. (mortgage)	6	17,308.66
RAC (auto)	1	9,516.14
<i>Total</i>	383	\$ 800,034.55

AOA examined all non-payroll transactions originating in thirteen other City accounts for the period July 1, 2005 through May 11, 2007. Many of these accounts are maintained separately for specific purposes such as grants, fund accounts, impact fees, and savings accounts. Although no fraudulent disbursements were identified, inappropriate activity was identified as follows:

- From 8/1/05 through 4/9/07, State Law Enforcement Assistance Fund (SLEAF) transactions totaling \$8,962.35 were deducted from the City's EIDE account.
- MSA activity for Fiscal Years 2006 and 2007 was not supported.
- \$2,700 was transferred from the City's Police Pension account to the City's payroll account. There was no support for this transaction.
- \$3,000 was transferred from the City's Library account to the City's accounts payable account. There was no support for this transaction.

In addition, transfers were made from other City accounts, that have no specific restrictions, to replenish the Payroll and Accounts Payable checking accounts. These funds would still be available to the City if they had not been used to cover the shortfalls in the other accounts. As a result, the City lost interest revenue and incurred \$55.00 in minimum balance fees.

Lowe's credit cards were issued to four City employees, including the former Finance Director. AOA reviewed 100% of the Finance Director's card activity for fraudulent transactions. Four transactions totaling \$975.57 were made during the card's active status. One transaction in the amount of \$908.02 was determined to be a fraudulent purchase. Transactions for the remaining three cardholders were sampled and determined to be appropriate.

CONCLUSIONS

AOA reviewed 100% of the former Finance Director's pay from January 1, 2006 through April 20, 2007 (last day of employment). Due to lack of supporting documentation maintained by the City, AOA was unable to examine payroll for the period July 1, 2005 through December 31, 2005. Although payments made to the Finance Director appeared to be in accordance with employment records, \$652.91 in net benefits were under-deducted from her pay.

City management reviewed an employee listing from the payroll system and determined there were no ghost employees. AOA tested payroll for a sample of the City's employees and determined pay was reasonable.

AOA reviewed 100% of the former Finance Director's pension activity for the length of her employment (January 6, 2003 through April 20, 2007). The pension activity was determined to be proper.

Based on the above results, the amount of funds embezzled from the City total \$801,595.48. In addition, other costs incurred as a result of the fraud include lost interest revenue and \$55.00 in minimum balance fees.

Checks	\$ 800,034.55
Lowe's Credit Card	908.02
Benefits under-deducted	<u>652.91</u>
Total	<u>\$ 801,595.48</u>

Prior to contacting AOA, the City identified 216 checks totaling \$546,387.04 as forgeries. AOA identified an additional 167 checks totaling \$253,647.51, \$908.02 in Lowe's Credit Card fraud, and \$652.91 in benefits that were under-deducted for a total of \$255,208.44 of additional fraud.

A weak control environment consisting of a lack of segregation of duties, management review, and reconciliations facilitated the resulting forgeries and fraud. The former Finance Director wrote fraudulent checks forging the signatures of the authorized signers and manipulated the accounting data in the general ledger accounting system. The former Finance Director intercepted the bank statements in order to remove the fraudulent checks; the employee responsible for reviewing the bank statement did not question the missing checks. Bank reconciliations were not prepared or reviewed by management. City Council did not receive monthly reports as required by City Charter 17.3 which states, "The Finance Director shall, at one monthly meeting of Council, present a report showing in detail all bills and other claims for which warrants or checks were drawn the preceding month, with exception of payroll and payroll-related expenses." Numerous transfers were made from other City accounts to compensate for the dwindling bank balances, none of which were authorized or reviewed by management.

CONCLUSIONS

Objective 2: Determine the adequacy of controls within the City and provide recommendations for strengthening controls.

The controls within the City are inadequate. The lack of knowledge of internal control and policies and procedures contributed to an environment conducive to fraud.

Based on interviews and inspection of documentation, AOA found the following:

Weaknesses

1. The City does not have written policies and procedures.
2. There was no written evidence of approval of purchase orders. The function of reviewing and approving purchase orders was a duty of the City Manager; this position is vacant. No other person was tasked with this function.
3. Department heads did not approve all invoices before payment. 1,303 invoices out of 4,057 tested (32%) were not initialed as approved for payment.
4. During the period of review, the Finance Director prepared the checks. After obtaining signatures, the Finance Director gave the checks and invoices to the Administrative Assistant to be stuffed in envelopes, mailed, and filed. This provided the Finance Director an opportunity to alter the checks and the general ledger system after the checks were signed. Currently, this process is still in effect except the City Clerk has replaced the Finance Director.
5. During the period of our review, bank reconciliations were not prepared and bank statements were received directly by the former City Finance Director. This lack of segregation of duties and management review created a weak control environment conducive to fraud. Currently, bank statements are not being reconciled; hence, the control environment is still weak.

During the interview process, several strengths were also identified:

Strengths

1. Checks and invoices are forwarded to the Mayor for review and first signature. Although the Mayor did not sign every check AOA examined, he signed a vast majority. Other checks were signed by other authorized signers.
2. Two signatures are required on all checks. Only 2 checks out of 4,057 tested had only one signature.
3. Blank check stock is securely maintained in a locked file cabinet. Checks are not pre-signed.
4. The City does not use signature stamps.

FINDINGS AND RECOMMENDATIONS

Written policies and procedures

Finding:

The City does not have written policies and procedures.

The Committee of Sponsoring Organizations of the Treadway Commission's report *Internal Control - Integrated Framework* (COSO) defines control activities as "...the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives...Control activities usually involve two elements: a policy establishing what should be done and, serving as a basis for the second element, procedures to effect the policy."

Management is responsible for establishing internal controls through written policies and procedures. Written policies and procedures are beneficial for identifying and ensuring that control objectives are met, as well as the training of current and new employees, and are a valuable resource in the event an employee leaves the City. Policies and procedures should be updated regularly and include sufficient information to permit an individual who is unfamiliar with the City's operations to perform the necessary activities.

Documentation is an important aspect of control and communication. It generally provides (1) an understanding of an entity's objectives, (2) a basis for training new personnel, (3) a means of communicating common information, (4) a source of information about accounting controls, and (5) a source of information that will aid in providing continuity in the event experienced personnel leave.

The lack of (a) knowledge of internal control and (b) policies and procedures contributed to an environment conducive to fraud.

Recommendation:

City management should:

- Review COSO and gain an understanding of internal control. This includes the five components of internal control: the control environment, risk assessment, control activities, information and communication, and monitoring;
- Develop written policies and procedures to ensure standardization in processing procedures and clarification of job duties. These policies and procedures should incorporate key controls such as segregation of duties, management review, reconciliation, etc. The City should consider hiring a consultant proficient in developing policies and procedures to assist with this process; and
- Provide effective oversight and monitor activities to ensure compliance with established policies and practices.

FINDINGS AND RECOMMENDATIONS

Segregation of duties

Finding:

The previous City Finance Director maintained the accounting records (Peachtree and Mainstreet), prepared checks, and prepared bank reconciliations. Bank statements were received and opened by the City Finance Director. This results in a lack of segregation of duties. The lack of segregation of duties and management review provided the City Finance Director an opportunity to (a) alter accounting records, (b) modify checks after authorized signatures were obtained, (c) prepare fraudulent checks, and (d) forge signatures.

The Committee of Sponsoring Organizations of the Treadway Commission's report *Internal Control - Integrated Framework* identifies segregation of duties as a control activity where "Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions...An appropriate segregation of duties often appears to present difficulties in smaller organizations, at least on the surface. Even (entities) that have only a few employees, however, can usually parcel out their responsibilities to achieve the necessary checks and balances." Segregation of duties is also identified as a monitoring activity. "Appropriate organizational structure and supervisory activities provide oversight of control functions and identification of deficiencies...Also, duties of individuals are divided so that different people serve as a check on each other. This is also a deterrent to employee fraud since it inhibits the ability of an individual to conceal his or her suspect activities."

Recommendation:

The City should segregate duties as much as possible with the limited staff. A management review process should be incorporated. For example, if the City Finance Director is tasked with preparing and mailing checks, then another individual should receive the unopened bank statement, and prepare the bank reconciliation. The reconciliation should be reviewed and approved by a management level position (e.g. City Manager or Mayor).

Approval of purchase orders

Finding:

There was no written evidence of approval of purchase orders. The function of reviewing and approving purchase orders was a duty of the City Manager; this position is vacant. The lack of documented authorization created a weak control environment in which purchases could be made without the approval or knowledge of management.

The Committee of Sponsoring Organizations of the Treadway Commission's report *Internal Control - Integrated Framework* identifies authorization as a positive control environment factor. Authorization is defined as, "the approval of transactions executed and access to assets and records in accordance with management's general or specific policies and procedures." Specific authorization relates to individual transactions; it requires the signature or electronic approval of a transaction by a person with approval authority. Assets must be safeguarded against unauthorized acquisition, use, or disposition.

FINDINGS AND RECOMMENDATIONS

Recommendation:

Purchases, especially those exceeding a certain dollar threshold established by the City, should be pre-approved in order to avoid over-spending and unnecessary expenditures and to promote a strong control environment.

Bank Reconciliations

Finding:

The City is currently not performing monthly bank reconciliations. Reconciliations are an essential control to ensure all transactions have been recorded and to identify potential improprieties.

The Committee of Sponsoring Organizations of the Treadway Commission's report *Internal Control - Integrated Framework* identifies reconciliations as a monitoring activity where as "...management obtains evidence that the system of internal control continues to function. When operating reports are integrated or reconciled with the financial reporting system and used to manage operations on an ongoing basis, significant inaccuracies or exceptions to anticipated results are likely to be spotted quickly...The effectiveness of the internal control system is enhanced by timely and complete reporting and resolution of these exceptions."

A reconciliation is a comparison of different sets of data to one another, identifying and investigating differences, and taking corrective action, when necessary, to resolve differences. Differences should be identified, investigated, explained, and corrective action taken as necessary. Reconciliations should be documented and approved by management. Effective internal control procedures require that reconciliations be performed on a timely basis to facilitate the prompt detection and correction of unrecorded or improperly recorded transactions.

The lack of bank reconciliations, management review, and monitoring contributed to a weak control environment and the ability of the City Finance Director to embezzle funds.

Recommendation:

The City should require:

- Monthly bank reconciliations;
- Segregation of duties related to accounting/financial functions;
- Management review of reconciliations; and
- Monitoring to ensure adherence to policies and procedures and to create a strong control environment.

FINDINGS AND RECOMMENDATIONS

Benefits

Finding:

Insurance premium benefits were both under-deducted and over-deducted from Christine Truitt's pay.

Medical	\$ 92.15 over-deducted
Vision	8.91 under-deducted
Dental	37.13 under-deducted
Aflac	861.17 under-deducted
AIG	184.62 over deducted
Pension	22.47 under-deducted
Net Total	\$652.91 under-deducted

The City of Harrington pays a portion of insurance benefits for its employees. The City pays a fixed amount of medical and vision insurance premiums which are determined each plan year plus 60% of the cost above the fixed amount. The City also pays for 60% of dental insurance premiums. The City does not pay any portion of Aflac insurance or AIG medical savings plans.

The City's policies and procedures are not adequately documented to ensure accurate payroll deductions are made from employees' paychecks. In addition, the City's payroll was not adequately reviewed by a person independent of the process. In total, \$652.91 of benefits were under-deducted from Christine Truitt's pay.

Recommendation:

The City should develop policies and procedures for payroll processing that include an adequate review process by someone independent of the payroll function to ensure segregation of duties.

Lowes Card Fraud

Finding:

During review of purchases made with Lowe's credit cards, one purchase in the amount of \$908.02 was determined to be fraudulent. The purchase and corresponding payment of the monthly statement was not approved or reviewed by a city department manager prior to payment.

The Committee of Sponsoring Organizations of the Treadway Commission's report *Internal Control - Integrated Framework* identifies authorization as a positive control environment factor. Authorization is defined as, "the approval of transactions executed and access to assets and records in accordance with management's general or specific policies and procedures." Specific authorization relates to individual transactions; it requires the signature or electronic approval of a transaction by a person with approval authority. Assets must be safeguarded against unauthorized acquisition, use, or disposition.

Recommendation:

All expenditures should be reviewed and approved prior to payment to prevent and detect fraudulent purchases and to ensure a strong control environment.

FINDINGS AND RECOMMENDATIONS

Inappropriate Transfers

Finding:

- From 8/1/05 through 4/9/07, State Law Enforcement Assistance Fund (SLEAF) transactions totaling \$8,962.35 were deducted from the City's EIDE account.
- MSA activity for Fiscal Years 2006 and 2007 was not supported.
- \$2,700 was transferred from the City's Police Pension account to the City's payroll account. There was no support for this transaction.
- \$3,000 was transferred from the City's Library account to the City's accounts payable account. There was no support for this transaction.

Each of these accounts has specific uses. Transactions in the accounts must be for allowable activity and must be adequately supported.

Questionable and disallowed activity could result in a loss of grant funding.

Recommendation:

The City should:

- Review disbursements from the accounts payable account and determine if any disbursements were valid uses of EIDE and Library funds; maintain clear support for the use of SLEAF, EIDE, and Library funds; and repay any unauthorized transactions from the EIDE and Library accounts.
- Maintain SLEAF activity separate from EIDE activity.
- Review activity related to MSA; document grant amounts received and allowable disbursements; and repay any unauthorized transactions.
- Research the balance in the Police Pension account; determine the purpose of the funds; and take appropriate action.
- Ensure that all grant and restricted funds are spent only on allowable expenditures by maintaining adequate supporting documentation for all accounts and transactions.

CITY'S RESPONSE TO FINDINGS

The following response to the Findings and Recommendations was provided by the City of Harrington:

"The City is down two key positions as of this report, the Operations Manager, and a Financial Position. The City is actively pursuing finding qualified persons for these positions. The Budget and Finance Committee is talking to CPA's to do the monthly bank reconciliations in the interim time, until the financial position is filled.

The City will be securing a financial consultant to make sure the City is in compliance with the COSO and how it applies to the City's structure in regards to developing policies and procedures. The City's staff is minimal, even when full-staffed, thus we will be looking for the consultant to suggest the best way to segregate the financial duties. In the meantime, segregation of duties has been strengthened according to your findings.

In regards to the Purchase Orders - A policy for Purchase Orders (10/31/03) was in place (a copy of that is available at the City). The Budget and Finance committee will review and make a recommendation to the full council in regards to the amount of the purchase that needs to be under a purchase order. A finding that purchase orders were sometimes verbal only applied to the timeframe after the incident, where department managers were asked not to spend any monies, even budgeted dollars without approval. This was in an effort to monitor cash flows in the last quarter of the FY.

The Budget and Finance Committee and Council will make sure that the recommended requirements of segregation of duties, management reviews, and a strong internal control are set in place, again with the first step being the review by a financial consultant.

In May, the City turned its payroll over to ADP, a professional payroll outsource company. The timesheets are signed off by department managers, and then submitted to the City's contact person for entering into the system. ADP provides a print out of the entire 'batch payroll' before checks are printed.

In regards to the section about inappropriate transfers: The Grant Accounts balance internally with the police department, which monitors the accounts and has the backup invoices. The previous Finance Director made transfers into the payable account that did not match the actual expenditures, but the bottom line is that the accounts balance with the invoices/receipts. This would apply to the Municipal Street Aid; SALE and EDIE funds.

Operating Procedures (SOP's) were in place, but we have not been able to find the written copies. This is mainly due to the change in staff, and the loss of the two key positions. With the aid of the consultant we will replicate the SOP's for the financial section of the operation, if the existing copies are not found."

DISTRIBUTION OF REPORT

Copies of this report have been distributed to the following public officials:

Executive

The Honorable Ruth Ann Minner, Governor, State of Delaware

Legislative

The Honorable Russell T. Larson, Controller General, Office of the Controller General

Other Elective Offices

The Honorable Joseph R. Biden, III, Attorney General, Office of the Attorney General

Other

Mayor and Council of the City of Harrington, Delaware

Ms. Cynthia Collins, Deputy Attorney General, Office of the Attorney General

Ms. Kathy Kunkle, Management Analyst III, State of Delaware Office of Pensions